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VOLUME 9 ISSUE 21

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Money isn't everything, but fiscal stringency is having considerable impact on state policies in most fields of state activity. One result has been to deter implementation of new initiatives in education, health care, and other areas. When state money is tight, education seems to be the disproportionate loser.

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States are paying a rapidly growing health care bill, but making little progress in reforming the system. Rapid Medicaid cost escalation is likely to continue, drawing money from other health activities as well as from other programs and from taxpayers.

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November 1991 (First Of Two November Issues)

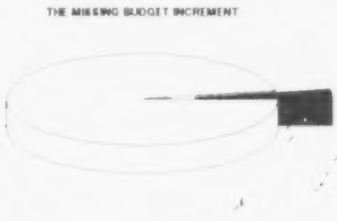
THE BUDGET PICTURE

Money Isn't Everything, But ...

This year state and local governments will be spending about $4,100 per capita, $12,000 for a family of three. That isn't small change.

If the economy had performed better during 1991, state and local governments might have spent $40-100 more per capita. Next year, perhaps a sluggish economy will take another $40-100 of what spending could have been. That isn't small change either, but illustrates the relatively small amounts at stake in incremental changes in state and local budgets.

Nonetheless, current state fiscal problems (Issue 20) are having major impacts on state policies in many fields. The coverage of current state developments in this issue is organized around those impacts. The impacts on state policies and on the public are much greater than the state revenue lost to the economic downturn. While large in dollar terms, $10 billion or so, it is a small piece of total state government spending as illustrated below.



Lack of new money cuts off policies that would involve states paying for activities not now in their portfolio. This precludes such initiatives as becoming a major force in subsidizing low income housing, providing expensive initiatives to broaden private health care coverage, and expanding welfare cash assistance to the near poor.

But does it necessarily cut off initiatives that aren't inherently expensive, such as altering how schools are managed or shifting recipients of welfare into the working world? Those questions are producing debate in many state capitols. So is the eternal question of whether money can be found for new initiatives by cutting low priority programs. Those questions will be particularly salient in late 1991 as many elected officials are desperate to avoid pre-election tax increases.

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The Budget Picture Isn't Bright

The financial status of the states was precarious going into the current fiscal year (FY 1992). It will remain precarious coming out of it, according to the official figures of state executive and legislative budget agencies as reported in the fiscal surveys of the National Association of State Budget Officers (NASBO) and the National Conference of State Legislatures (NCSL). The key figures from the two surveys are shown in Table 1.

Table 1: Summary Financial Statistics From Two Recent Surveys ($ billion)

Category	NCSL	NASBO
Spending, FY 1991	$283.9	$287.2
Spending, FY 1992	$297.8	$301.5
Percent Increase in Spending	4.9%	5.0%
Balances At End FY 1992	$2.1	$4.1
Balances Plus Rainy Day Funds As Percent Of Spending	2.0%	1.9%

Both surveys reflect spending increases of roughly the expected rate of inflation. Revenues are slated to rise somewhat faster, reflecting tax increases and a need to rebuild balances. With spending overall only growing to match inflation, with Medicaid and corrections growing faster than inflation, and debt service growing in many states, many other programs will see increases below the inflation rate. New initiatives that cost money are understandably scarce.

Economic recovery, which is not a sure thing, could improve the outlook in FY 1993. But the environment for new initiatives won't improve much. The combination of the problems of FY 1991 and the problems developing this year means most states will be carrying a full load of fiscal baggage into FY 1993. This load will have a high priority claim on available resources. The baggage includes: (1) temporary taxes scheduled to expire, (2) one-time revenue items requiring spending cuts unless other one-time items can be found, (3) unpaid loans to other state funds, (4) payments in arrears to local governments, vendors, and state employees, and (5) deferrals of outlays for equipment, promotions, major maintenance, and capital outlays.

In short, those interested in major new initiatives from the states need to be interested in the prospects for tax increases in most state situations. Conversely, those interested in avoiding tax increases need to be interested in the new initiatives, as well as the continuing costs, that might seem to require them.

Voters And Taxes

November 5 will go down as a day the whole country will remember. It sent the message ... people want less taxes and less government.

This was the post-election comment of Chuck Haytaian who will become the new speaker of the New Jersey House in January when Democratic majorities in both Houses are replaced by veto-proof Republican majorities. This was one of the biggest one-year partisan turnarounds in history. The Republicans campaigned against the 1990 tax increases and Governor Florio's record to unseat Democrats who were supportive of the governor on tax policy, auto insurance reform, and other issues.

The New Jersey Message: A strong case can be made that the New Jersey vote *does not* carry any implications outside New Jersey because of unique factors there. But the operative question is not whether objectively New Jersey is unique but rather whether legislators in other states think it is unique.

The New Jersey tax increase wasn't as easy to sell voters as others around the nation. First, many voters read candidate Florio as pledging no new taxes in November of 1989 and proposing a whopping tax increase several months later. Second, the 1989 campaign promised an intensive effort through task forces to find savings in existing spending patterns. The savings effort really didn't get underway until after the tax increase was being pushed and hasn't produced any well-publicized savings.

Third, taxpayers never understood the complex link -- the school aid formula -- between state tax increases and promised local property tax relief. Fourth, the tax measure became and stayed a highly partisan issue -- much more than in other tax-raising states like California and Pennsylvania. Fifth, the measure and the process of its enactment alienated some groups usually supportive of such measures, particularly teachers. Sixth, attempts to patch the 1990 legislation created more political problems as the state took a tough line in its labor negotiations and withdrew some of the previously enacted education aid.

The Missouri Message: A less ambiguous signal was sent by the 622,468 Missouri citizens who said no to the tax increases (sales, personal income, corporate income, tobacco) and education funding measures on the November ballot. The 303,653 citizens voting yes were only about a third of the vote. By just about any measure, Missouri is one of the lowest spending states in the nation. The tax increase was endorsed by the Republican governor, Democratic legislative leaders, and interest groups of many kinds. Proponents outspent opponents by a wide margin.

There isn't a long list of special circumstances to explain the lopsided vote. One may have been the running dispute between state officials and a federal district judge that received considerable publicity just before the election. The case has been drawing state tax funds from the rest of the state to support a Kansas City school system that is considerably

more expensive and arguably less well managed than others. Just before the election, the governor announced that aid to other school districts would have to be reduced to cover the costs of a new court order requiring the state to pay for the district's extensive construction program.

Legislators Look At Taxes

Another factor affecting whether taxes will be raised to pay for current and possible new state programs is legislators' attitudes. They can't be quantified, so readers must rely heavily on their own observations. It appears that candidates for local and state office this year stressed more than usual their objections to taxes and spending levels.

Whether the 1991 elections show a change in the intensity of opposition to state tax increases or not is debatable. What isn't debatable is the intensity of opposition already. "Just say no" to new taxes has already had a major impact on state spending patterns.

Pressures For Tax Increases Next Year

This year many states didn't raise taxes or raised only minor levies by minor amounts. Some avoided tax increases because they could make spending on current services more or less conform to the revenues available from current taxes. Such states, along with states that made major increases in 1991, may well avoid tax increases in 1992. With economic recovery, some other states could fund current services without tax increases in 1992. But some couldn't without significant spending cuts. The list of states needing major tax increases or major spending cutbacks in 1992 is debatable, but looks something like this:

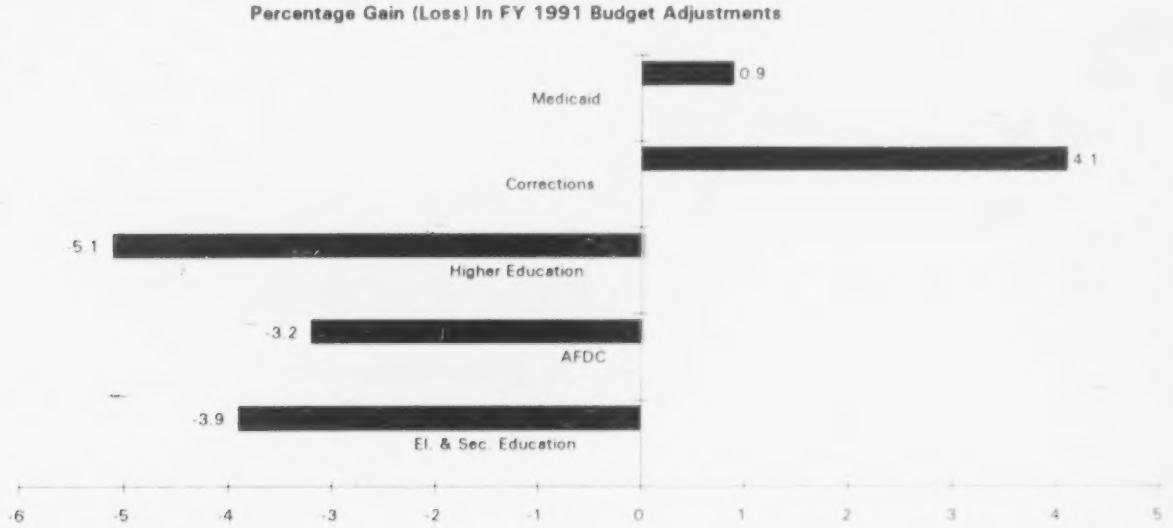
Colorado	Georgia	Indiana
Iowa	Kansas	Michigan
Mississippi	South Carolina	Tennessee
Virginia	West Virginia	Wisconsin
	Wyoming	

Officials of these and other states will face the tax issue again in 1992, along with officials in states like California and New York where this year's budget-balancing measures appear to have fallen short.

In its new **TaxWatch**, State Budget & Tax News (Issue 21) predicts that some are likely to raise taxes. But whether they do and the consequences of holding the line will be key issues in the next sessions. Colorado's special session this fall was a preview of the action.

Who Loses In Austere Times?

When budgets are tight and tax increases aren't an option, programs get squeezed. This squeeze is most traumatic when it occurs after a budget has been enacted. Procedures vary by state on whether the governor or the legislature has authority to make the cuts, but every state has a mechanism to withhold spending of appropriations already made. While sometimes announced as across-the-board cuts, most of these cuts have had quite unequal impacts. The chart shows what happened to spending in FY 1991 after appropriations were approved.



While there are some problems in compiling these figures as explained in the Technical Appendix, the chart correctly portrays an unequal outcome among programs. Medicaid and corrections got substantially more money in FY 1991 than in the budgets originally approved for them.

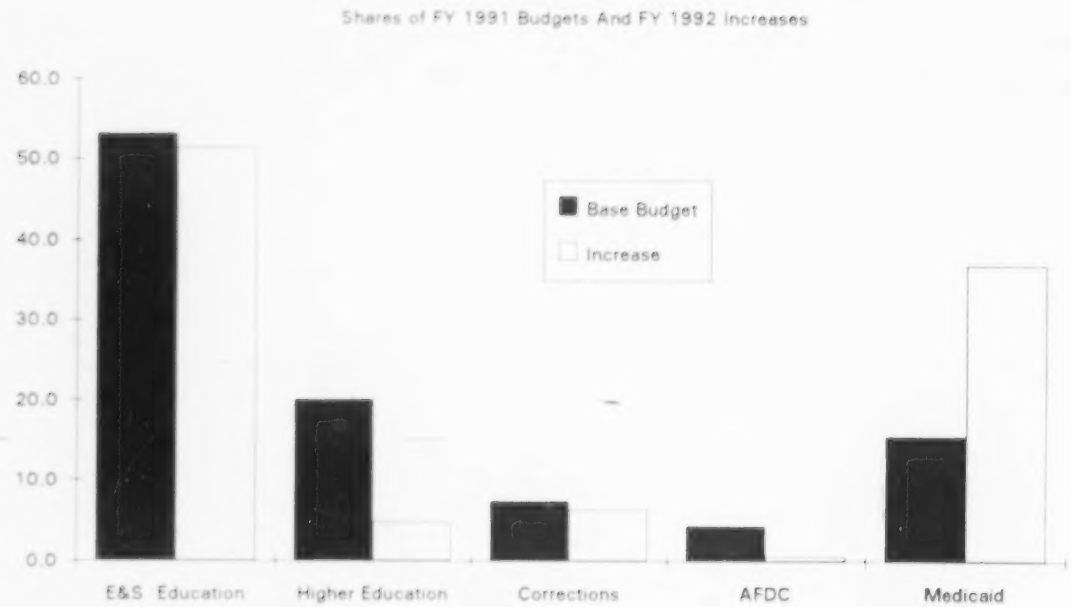
Where did the money come from? It didn't come from unexpected revenues because revenues in FY 1991 were lower than anticipated when budgets were passed. So it came: (1) from the mid-year cuts in education and AFDC shown in the chart, (2) from tax increases, and (3) from running down balances which ultimately will be replenished at the expense of other programs and the taxpayers.

Who Loses This Year?

The dramatic mid-year adjustments made in FY 1991, as shown on the chart above, mean that the enacted FY 1992 budgets need to be taken as less a blueprint for spending

and more as a hint of spending decisions to come. If past patterns are followed, Medicaid and corrections will exceed budgeted increases.

Even before the mid-year adjustments are made, the enacted budgets reported by legislative fiscal officers indicate major changes in priorities. The chart below compares the FY 1991 percentage shares that five major programs took of the total for the five of them and, in the second bar, the shares they took of the increases voted for FY 1992.



This shows that in the budget battles earlier this year elementary and secondary education held its own with about half of general fund spending for the five programs shown and half of the increases. Medicaid made a major gain at the expense of the other programs, particularly higher education. While corrections and AFDC may recoup their losses through supplemental appropriations, higher education will not. Because spending patterns for the 1991-1992 academic year have been set based on approved state budgets, the need for supplemental appropriations to finish the year doesn't arise.

The chart deals only with shares of appropriations for the five programs. The biggest losers of all were those not reported separately. The appropriations for the "all other" category were actually reduced. Particularly vulnerable items in this category have been: (1) capital outlays funded out of general revenue, (2) unrestricted aid to local government, and (3) general fund spending for programs often funded out of special funds such as transit, highways, and regulatory activities.

HEALTH CARE

Interest Grows In Health Care Solutions

If criminals have a right to a lawyer, I think working Americans should have a right to a doctor.

This was one of Pennsylvania Senator Harris Wofford's standard one-liners. Journalists, political analysts and pollsters suggest that his emphasis on health care was a major reason for his upset victory over former Governor Thornburgh. The perception that health care has become a highly significant issue to the American voter appears to be increasing the willingness of federal and state elected officials to offer proposals to deal with the subject.

The prospects for federal-state conflict are great. Many state officials prefer that the subject be handled primarily by a nationwide plan, such as some form of national health insurance. Even those preferring less comprehensive federal roles need federal approvals for actions such as: (1) waiving Medicaid rules to permit state experiments like Oregon's, (2) altering the Employee Retirement Income Security Act to permit states to regulate collectively bargained health plans as Hawaii does, and/or (3) providing for state flexibility in regulating providers as California seeks. Federal officials seeking to act are considering altering state policies by preemption of regulatory authority over health insurance plans, mandates in the Medicaid program, and preemption of state tort laws.

New Federal Proposals Appear

The Bush Administration position is that major health care reform should wait until after the 1992 elections. No specific proposals are on the table, though the President has indicated he will be addressing health care solutions in the 1992 campaign.

Some key Democratic Congressional leaders are pressing for at least some action on a faster schedule. The stalking horse is legislation offered in late October by Senator Bentsen and Representative Rostenkowski, chairmen of the key financial committees of the Senate and House. The legislation is designed to preempt the states in many aspects of health insurance regulation. The enforcement mechanism is indirect. If insurance companies don't comply, they would be subject to special federal taxes.

The legislation wouldn't put new money into health care with a limited exception. Corporations can now deduct money spent on health insurance for employees, but self-employed persons can only deduct a part. The bills would make this treatment comparable.

With that exception, the benefits of the legislation to some firms and their employees would have to be costs to other firms and employees. This leads to the same

problem that states face in insurance regulation of all types. The costs of insurance for high risk persons, such as individuals with difficult medical conditions or drivers with long accident records, is often more than they can reasonably be expected to pay. But others also find insurance expensive to the point where many don't carry it. The high cost rates can be cut by increasing the regular cost rates -- a controversial step for the states and for the federal government.

A state agenda for federal action was presented by National Governors' Association Executive Director Raymond Scheppach in Congressional testimony in late October. As adopted by the governors this summer, it includes new federal programs for dealing with the uninsured, as well as relaxation of some federal rules to allow greater state experimentation.

It is unlikely that any of the major proposals for federal legislation will be adopted before state legislatures meet next year. This will leave state officials in a position of uncertainty about future federal policy as they attempt to fashion state-level solutions. This, of course, isn't a new situation.

New State Proposals Appear

There has already been heavy state activity on the insurance coverage issues addressed by the Democratic leaders in Congress. State Health Notes (10/7) counts 15 states acting this year on such issues as guaranteeing policy renewal, limiting premium increases, and guaranteeing availability of insurance to small business.

Most legislatures aren't in session now, but Michigan's is -- with health care a major topic. Its Senate recently passed a major package. In general, Democratic legislators around the country have been more comfortable with extensive state involvement in comprehensive health care plans than Republicans. The Michigan legislation is indicative of those alternatives being considered in the states that don't involve substantial budget outlays (but do involve substantial costs). Don't look for immediate enactment even though the legislation passed the Senate. It is common in Michigan for the Senate Republican majority to pass legislation on major topics and the House Democratic majority to pass different legislation on the same topics, with no legislation ever enacted.

The Michigan bills provide for substantial tax credits to encourage purchase of basic health insurance coverage. Credits would go to businesses with extraordinary health insurance costs and to companies that become first-time buyers of employee health insurance. Blue Cross/Blue Shield would be required to offer a basic plan to individuals at a price of about $120 a month for family coverage bought through a group ($180 for individually purchased policies). Losses from these policies would presumably be spread over other Blue Cross customers. In addition, the purchasers' costs would be reduced by personal tax credits of up to $60 a month.

For children who didn't obtain coverage by any other mechanism, the state would provide coverage in the Blues' minimum plan. That cost, estimated at $40 million, would come from somewhere in the unsubsidized component of health insurance. Sponsors mentioned using the component of reimbursements for hospitals associated with capital outlays. There is also a provision to restrict medical liability and thus reduce the malpractice insurance component of health costs.

Bootstrap Financing Still At Risk

The issue of using voluntary contributions and provider taxes to finance the state share of Medicaid has now drawn attention commensurate with its significance for both health care and the condition of state budgets.

Compromise negotiations between state and Administration officials are underway. They contemplate significant restrictions on what some states are doing, including: (1) eliminating voluntary contributions, (2) restricting provider taxes, particularly those tied to how much providers get from Medicaid, and (3) limiting how states handle "disproportionate share" financing of hospitals serving large proportions of low income patients. By "grandfathering" some current state plans and transition provisions, the compromises would avoid the sharp mid-year effect on some FY 1992 state budgets that would occur if regulations offered earlier this year were allowed to go into effect as drafted.

With no compromise, the range of outcomes is bracketed by the current draft of the regulations and the proposed Congressional action, the Medicaid Moratorium Amendments of 1991. The moratorium bill would block new adoptions of voluntary contributions and phase out existing uses while protecting provider taxes through the fall of 1992. The regulations would theoretically go into effect in January, but contain a provision that would permit all states to continue most current practices through June.

The net effect of all alternatives will be to force some states to drop some Medicaid financing mechanisms they now use. The issues are how many and when. The effect is that some states will have to act in early 1992 to find new methods of financing part of their Medicaid costs.

Even as this activity is occurring at the federal level, states are relying more on bootstrap financing. Plans adopted by some states in their FY 1992 budgets are being implemented and some states (e.g., New Hampshire and West Virginia) are holding special sessions to adopt plans.

Reimbursement Rates Rise Under Legal Pressure

Major increases are being made in state Medicaid reimbursements to health care providers as they flex new legal power to force states to pay more.

Providers -- hospitals, nursing homes, doctors, pharmacists, and others -- have been contending for decades that states don't pay them enough for Medicaid services. Short of refusing to accept Medicaid patients, their redress was in the legislative and administrative forums of the states. In a case decided last summer, the U.S. Supreme Court considered a Reconstruction Era civil rights statute, along with the federal Medicaid statute indicating reimbursement should be "reasonable and adequate," to find providers had standing to bring suits against states over rates.

The result has been a rash of litigation. By one count, suits have been filed by hospitals in 21 states and by nursing homes in 20. But the count doesn't matter. The threat of litigation is a factor in negotiations even where no suit has actually been filed. And filing a suit is sometimes a step in seeking a negotiated rate, not a determination to obtain a judicially set rate.

"Reasonable and adequate" isn't a precise standard and there are few cases to define it. So negotiated settlements are common even in advanced stages of litigation. This is what happened in Washington where a negotiated settlement was developed after a U. S. district court decision supporting the hospitals' position. The result is a 10% increase in rates. If other states incurred the same per capita costs, the decision means about $3.2 billion annually in added costs, of which about $1.4 billion would be state funds and the rest federal. Adding in similar settlements for other providers, particularly nursing homes, raises the ante further.

How Much Pressure Will Medicaid Put On State Budgets?

Medicaid was a chief culprit on the spending side that contributed to states' overall budget dilemmas.

This comment in the NCSL fiscal survey describes Medicaid as a source of current fiscal problems. It may be the source of future fiscal problems as well, as many state budgets apparently don't anticipate the costs likely to be incurred. NCSL itself calls sticking to FY 1992 budget plans "a near impossibility." It continues by noting the 21.8% increase budgeted by the states "may underestimate what amount states will actually spend on Medicaid."

The real costs of Medicaid are determined by such factors as how many people are eligible, what services are provided to those people, and what reimbursement rates are used to determine how much to pay for those services. But the budgetary impact of Medicaid in any particular year is determined both by those factors and by decisions on how much to appropriate for Medicaid, when to appropriate, and how to account for certain aspects of Medicaid spending.

These arcane topics have had substantial impacts on the fiscal outcomes in the states, including impacts on spending for other programs and on the perceived need for

increases in state taxes. The impacts of past decisions on how to treat Medicaid in the budget (as distinct from how to treat it in the real world) are still appearing. They are a part of the reasons for recent shortfall announcements in California and New York. Their consequences now appear in the debt service costs of Massachusetts government. Their consequences will soon appear in discovery that the balanced budget recently adopted by the Michigan legislature isn't balanced.

The Hidden Medicaid Budget

Serious Accuracy Problems: The rapid escalation of Medicaid costs has brought out some of the least attractive aspects of state budgeting processes. The amounts appropriated have not corresponded to the amounts spent or, in many states, even been close.

This may be an indictment of the accuracy of state estimating procedures, with errors that far exceed what are considered acceptable when comparable deviations between estimated amounts and actual amounts appear in revenue estimating. It may also indicate a lack of candor by state officials who are reluctant to show the degree to which they are allowing other programs to be squeezed by Medicaid and the extent to which tax increases are required because of Medicaid cost increases.

Timing Of Spending: In some states, the Medicaid spending numbers are indicative of the potentials for distortions of financial reporting to occur when cash rather than accrual accounting is used *and* payment practices are changed to deal with budget problems. In normal circumstances, Medicaid bills of, say, $100 million a month would be incurred by patients using health services and $100 million a month would be paid about two months after services were rendered. Cash and accrual accounting systems would both report an outlay of $100 million for the month. The cash system would be reporting bills when paid and the accrual system would be reporting bills when incurred, but the reported costs would be about the same.

But suppose the state decides not to pay during a particular month, lengthening the billing cycle to 90 days from 60 days. Under accrual accounting, the expense for the month is still $100 million, but under cash accounting, the expense is zero. When catch-up occurs, the cash system would report a double outlay of $200 million while the accrual system would still report $100 million. What works for a month works for a year, so apparent costs can be reduced by one twelfth by skipping a month of bill paying.

When the practice is not fully disclosed (or the significance of obscure disclosures not understood), it can lead to persistent imbalance in state budgets and ultimately to tax increases. This is a major part of the West Virginia fiscal story in the late 1980s and the Massachusetts fiscal story from 1988 through 1990.

Use Of Special Funds: Medicaid also illustrates the impact on financial reporting when multiple state funds support a single activity. Some states are apparently taking provider donations and other bootstrap financing money into special funds, rather than the general fund. As a result, the sharp increase in funding from these sources won't appear in general fund budget totals. In NASBO's reporting on FY 1991 spending, state general fund spending for Medicaid increased by 17.2% but the much smaller category of other fund support of Medicaid grew by 125%.

Wide Differences Between Budgeted Amounts And Spending: All of these difficulties in accurate reporting -- and thus in understanding by elected officials, lobbyists, and the public -- appear in the statistics shown on Table 2.

Table 2: Percentage Increases In FY 1991 Medicaid Spending

State	Budgeted	Actual	Supplemental
Relatively Normal Patterns			
California	14.1%	21.0%	7.0%
Texas	14.7	27.9	13.2
Ohio	8.9	20.7	11.8
Michigan	-2.3	13.5	15.9
New Jersey	13.7	30.7	17.0
Virginia	19.1	28.6	9.5
Indiana	24.5	22.3	-2.2
SEVEN STATES, Average	13.2	23.5	10.3
Spending Below Appropriations			
UNITED STATES, Total	13.8	9.9	-3.8
Florida	60.3	48.7	-11.6
Georgia	34.0	27.9	-6.1
New York	11.8	-8.8	-20.6
Illinois	6.4	-42.0	-48.4
Unlikely Spending Increases			
Missouri	11.7	35.2	23.5
North Carolina	19.1	69.0	49.9
Pennsylvania	4.3	59.0	54.7
Unwilling To Report			
Massachusetts	21.9	n/a	n/a

Table 2 is based on legislative fiscal officers' reports to NCSL for its annual fiscal survey. **Reports** compared three figures from the largest 15 states, which have two-thirds

of the nation's population: (1) what was spent for Medicaid in FY 1990, (2) what was approved in the FY 1991 budgets for Medicaid as reported last October, and (3) what was actually spent as reported this October. The results are shown as percentage changes. For example, California budgeted for a 14.1% increase but finished the year with 21% higher spending, requiring supplemental appropriations authority of 7%.

The results are literally incredible, in the sense of not being believable.

The gap between estimated increases and actual increases was more like a chasm. The average deviation between predicted and actual increases was 21% -- like estimating a 10% increase and getting an 11% cut or a 31% increase. By contrast, estimating errors of 2% or less are common in revenue estimating and a large error, like failing to predict a recession, would be in the 4-8% range at most. The chasm has three components contributing in unknown proportions but all producing less than complete accuracy: (1) misestimates of caseload and cost, (2) deliberate misreporting, and (3) policy changes after the budgets were enacted.

Besides being large, the errors are in the wrong direction. State officials spent FY 1991 complaining about unanticipated costs, escalating provider charges, increasing caseloads, and unbearable mandates in Medicaid that increased their costs. Cost increases caused by these factors were cornerstones of complaints to the federal government about mandates, sharp cutbacks in other state spending, and tax increases. But as shown in the US total line on Table 2, the percentage increase nationally was less than originally budgeted.

The aberrations in individual states are large enough to affect what is reported as national totals. Medicaid costs are increasing in the 15-25% range nationwide with deviations above and below in individual states as shown in the seven states with relatively normal patterns. This range is reflected in state reports on actual spending and in the reimbursement claims states make for federal cost sharing. It isn't reflected in the national total shown on the table because the large negative growth numbers from some states drag down the national increase to 9.9%.

Underbudgeting For Medicaid: Table 2 tells many other stories, all significant for those interested in taxes and non-health programs such as education.

First, budgeting and reporting Medicaid spending exhibit many abnormal patterns. Seven states had normal patterns. Seven didn't. One (Massachusetts) didn't report at all.

Second, it is a normal pattern for Medicaid to be underbudgeted. In the seven "normal" states only 56% of spending was budgeted while 44% was left for supplemental appropriations. On an unweighted average basis, legislators and taxpayers of those states signed up for a 13% increase in Medicaid and wound up buying a 24% increase.

Third, there are interesting stories in the other states. The large negative for Illinois doesn't represent real savings but a deliberate decision to get through the 1990 legislative session without major tax increases by lengthening the Medicaid bill payment cycle. Total spending in the year drops for the same reason it would if a homeowner skipped a couple of mortgage payments. New York's decline probably is a smaller dose of the same medicine.

That Illinois would delay paying Medicaid bills in FY 1991 to lower spending and avoid a tax increase may not be laudable financial practice, but is understandable. But why would Missouri, North Carolina, and Pennsylvania increase their spending? One plausible reason is to get money for a cause perceived as not being popular out of the limelight by moving it from the new FY 1992 budget to the obscure FY 1991 supplemental budget. Each state adopted a tax increase for FY 1992. By shifting cost overruns in Medicaid to FY 1991, the tax increase could be discussed as being necessary for state programs across the board.

ELEMENTARY AND SECONDARY EDUCATION

Where Has All The Money Gone?

This wasn't a good year for the public schools. At least not if the measure is state money.

On the surface, the schools did well. The NCSL survey shows state budgets for elementary and secondary education for FY 1992 represent an increase of 8.9% over FY 1991. This is a much greater increase than the 4.9% for state budgets overall and clearly superior to the 2.2% increase for higher education. But there is much less in these numbers than initially meets the eye. Table 3 provides the state-by-state detail and suggests why.

While the national average increase beats inflation by a substantial margin, there are special explanations associated with the states making the large increases that take the average so high. They are indicated on the tables by symbols for tax increases ($) and special situations (*). Most of the states with large increases, those shown in the first column of Table 3, have one or the other.

Special situations are illustrated by Rhode Island and New Hampshire, both of which also had to increase taxes to enact balanced budgets and may, in the course of the year, have to curtail spending to maintain them. Rhode Island shows a dramatic jump in school spending between FY 1991 and FY 1992 because, as an austerity measure, it failed to make two of its 12 monthly school payments in FY 1991. Continuing deferral in FY 1992 would make 12 payments compared to 10, or a 20% increase. Catching up a month, which is the current plan, provides a 30% budgeted increase, but no real increase from the perspective of those interested in education.

New Hampshire has essentially eliminated its state school aid, leaving the schools primarily reliant on local taxes and whatever is available from dedicated lottery funds.

Table 3: Increase In State FY 1992 Elementary And Secondary Education Budgets

Rank	State	Percent	Rank	State	Percent	Rank	State	Percent
1	Rhode Island $*	29.5%	17	Idaho	8.8%	34	Florida	3.4%
2	New Hampshire $*	28.7	18	Oregon	8.3	35	Colorado	3.3
3	California $*	21.9	19	Iowa	8.2	36	West Virginia	2.9
4	New Jersey $	21.8	20	North Dakota	7.5	37	Vermont	2.6
5	Hawaii*	18.7	21	New Mexico	6.6	38	Montana	1.4
6	Nevada $	18.7	22	Mississippi	6.2	39	Louisiana	1.3
7	Arkansas $	14.2	23	Indiana	5.9	40	Georgia	1.2
8	Maine $*	12.9	24	Michigan	5.8	41	Alaska	1.1
9	Nebraska $	12.3	25	Maryland	5.7	42	Missouri	0.5
10	Washington	11.1	26	Arizona	5.6	43	Alabama	0.4
11	New York*	10.1	27	Utah	5.4	44	Illinois	0.4
12	Ohio*	10.1	28	Wisconsin	5.3	45	South Carolina	0.3
13	Pennsylvania $	10.0	29	Wyoming	4.9	46	Kansas	-0.9
14	Oklahoma $	9.9	30	South Dakota	4.7	47	North Carolina	-1.2
15	Kentucky $	9.8	31	Connecticut $	4.6	48	Tennessee	-6.4
16	Texas $	9.2	32	Minnesota	4.1	49	Virginia	-6.4
	United States	8.9	33	Delaware	3.7		Massachusetts	n.a

Tax increases are illustrated both by states that increased taxes to maintain current spending patterns (e.g., California and Maine) and by the states that increased taxes this year or last year explicitly to increase education funding. This accounts for large increases in states such as New Jersey, Arkansas, and Oklahoma.

The Outlook For State School Funding

California's Proposition 98 expresses the minimum aspirations for state funding of those interested in schools in all states. First, they want to maintain "their share" of state budgets. In FY 1992 nationwide, this meant a 4.9% increase or more. By this test, adequate funding for schools was provided by 28 states as shown on Table 3. The second test is to cover current services defined as increases from the previous year for inflation and enrollment increases. Nationwide, that would be about 1% for enrollment and 4-5% for inflation. Enrollment change varies among the states from significant declines to increases of 3% or more. Probably about half the states met this test also. Proposition 98 requires state funding at a level sufficient to pass both tests.

Table 3 shows the close ties between economic growth, tax increases, and large increases in state aid. The large increases without tax increases were in states that have been substantially more prosperous than the rest of the nation, particularly the Northwest. The other large increases not associated with special situations (*) were in the states with large tax increases.

These close ties suggest how education funding is likely to fare for the next several years. In states with slow economic growth and no major tax increase, funding increases are likely to be at or below inflation as illustrated this year by nearly half the states. Faster state economic growth offers faster state revenue growth in which education will likely share in competition with other programs. But truly large funding gains depend upon the kinds of tax increases recently rejected by voters in Missouri and approved by voters in Oklahoma.

The Outlook For Education Quality Measures

In the practical political environment of the state capitols, there generally has been a close association between adoption of eduction quality measures and large infusions of state money into elementary and secondary education.

This tie has a clear base in reality where the state's quality measures include mandates of smaller class sizes, higher teacher pay, and new programs for pre-kindergarten youngsters. These quality measures are clearly costly.

The tie is more political than economic when the state mandates deal with such issues as student and teacher testing, teacher tenure, and relative power of teachers, principals, and school district administrators. But the tie is real. For example, as the price of his support for the proposed Missouri tax increase, the governor (and many legislative leaders) insisted on a long list of education reforms. There are many examples of reform being resisted by teachers and/or administrators because the proposed reforms weren't to be accompanied by funding increases.

Will there be a new wave of education quality measures comparable to the recent Kentucky and Oklahoma plans? It is difficult to see where they might develop, particularly in 1992. Officials of many states will be trying to avoid or minimize tax increases, sacrificing all new initiatives and maybe a few old ones in the process. In some states, the willingness to raise money for education may go to funding school finance equalization measures, not educational quality measures.

As a result, the emphasis will likely have to be on implementing the many educational quality iniatives that have already been passed. Legislators seeking to advance new quality measures may be forced by fiscal circumstances to focus on those without major cost implications.

ECONOMIC DEVELOPMENT

United Airlines Selects Indiana

> *I am pleased to announce today that the largest economic development project in the United States is coming to Indiana.*

With these words, Governor Bayh touted the new United Airlines maintenance facility offering 6,300 jobs at an average salary of $45,000 each, $800 million in capital outlay, 11,680 jobs from indirect effects, and $100 million a year in new local purchases by the airline.

The facility has been the subject of intense competition, as previously covered in **Reports**. Bayh claimed Indiana won "not because we had the best economic incentive program, but because we had the best combination of factors including incentives, site availability, location, weather and quality of workforce." United Airlines cited about the same factors in its press release and called the competition close and the other proposals outstanding.

Indiana's incentives are $171.5 million which works out to about $25,000 per direct job gained. There are also local incentives valued at $111.5 million. Press reports indicated that Colorado and Oklahoma offers were in the same ballpark. Kentucky dropped out of the competition which its governor suggested had become a bidding war. Comparing bids is difficult because the offers frequently aren't publicized and concessions aren't valued by the same methodology.

The agreement between Indiana and United has provisions often missing in such agreements. Should United not maintain the facility for the stipulated time, Indiana gets its money back.

Is Competition Ruining State Policy?

The scramble for United Airlines illustrates to some the presumed evils of interstate economic competition. Critics are concerned that states will give away the store by tax breaks, infrastructure concessions, and financing. They fear this will increase spending while reducing the tax base, thereby throwing more costs on other businesses and individuals. They worry that competitive pressures to hold down business taxes will promote an unfortunate competition to curtail spending on social programs while redistributing the costs of what is left to individual taxpayers through regressive taxes. They see the competitive process itself as costly for no reason as states are playing a zero-sum game.

Others see competition among states through policy choices as the same healthy process as competition among companies through product options. While more rough and tumble than more structured choices of a planned economy, they believe competition drives state elected officials into efficient policy choices in a way that elections alone could never accomplish. The results are pressures to minimize waste, create high quality educational systems, maintain a good road system, and more.

Prominent experts on federalism and public finance fight out these and other issues in Competition Among States And Local Governments (Urban Institute Press, 1991). The book's editors (Daphne Kenyon of Simmons College and John Kincaid of the Advisory Commission on Intergovernmental Relations) view their effort as a reassessment of thinking on competition issues reflecting "a growing realization of the potential benefits that competition can provide for the citizens of the competing governments." The many authors of the chapters don't all address the same issues and don't always agree when they do. So **Reports'** summary assessments below aren't a substitute for reading the book for those deeply concerned with these issues.

Competition Affecting State Tax Policy

Competition will tend to drop the level of state and local taxes on mobile business activity, like manufacturing or United's maintenance base, to costs of government services provided. This clearly includes transportation and police protection while clearly excluding welfare and leaving education debatable. Other factors, such as the public's preference to tax business rather than individuals, will tend to mitigate this effect.

Competition would tend to hold down the top bracket rates of state income taxes. There is evidence of this occurring in the late 1980s, though mostly in the nature of dropping rates from above 10% to below that figure rather than affecting states with rates in the 5-8% range. An argument can be made that competition would encourage states to rely less on income taxes and more on other taxes and/or make their income taxes less progressive. There is no evidence that this has been occurring.

Competition Affecting Spending Policy

Competitive pressures discourage states from getting too far out of line with other states in their overall level of taxes and thus of spending. But the pressures stimulate spending as well, encouraging states, for example, to avoid an education system that is significantly weaker than those of competitor states. Among spending choices, competition encourages emphasis on activities considered important to business, such as infrastructure and education, rather than social welfare.

Competition Affecting Federal Policy

For those who believe competition is unduly destructive of "ability-to-pay" taxes (like graduated income taxes) and unduly depresses social welfare spending, the appropriate federalism choices are simple. The federal government becomes the prime user of the ability-to-pay taxes, perhaps with some sharing of tax base with the states as now occurs with the estate tax. The federal government pays for social welfare policies (e.g., Food Stamps), provides grants to share in the costs (e.g., Medicaid), or mandates certain minimum standards for states (e.g., Medicaid coverage of pregnant women and welfare for two-parent families). Because these federal policies effectively take the decisions out of interstate competition, those who favor the impacts of competition don't like the policies.

Do Competitive Efforts Make Any Difference?

There is continuing debate over the effectiveness of state economic incentives on business location and expansion decisions. Timothy Bartik enters the debate in Who Benefits From State And Local Economic Development Policies? published this year by his employer, the Upjohn Institute. He concludes that state and local policies do affect growth. Based on complex calculations, he concludes that, "A state and local business tax reduction of 10%, without reducing public services to business, probably increases business activity in a state or metropolitan area in the long run by 2.5%."

Bartik argues that state and local development efforts are not a zero-sum game because they result in steering expanded economic activity to depressed areas where much of the activity will use workers and other factors of production that would otherwise be idle. He gives state and local development efforts two cheers, denying the third because efforts aren't always concentrated in geographic areas with the highest unemployment and because state and local officials sometimes spend too much on concessions to lure particular firms.

TAX POLICY

Debating State Taxes On Business

Introduction: There seems to be little consensus among state officials on business tax policy, at least if a National Conference of State Legislatures October conference is an indicator. The conference, titled "Exploring Business Tax Policy For The 1990s," drew state legislators, academics, state tax experts, and business leaders into two days of discussion of a wide range of tax issues.

Defining Business Taxes: State officials, business leaders, and others involved in tax policymaking aren't all talking about the same thing when they discuss "business taxes," according to William Fox (U. of Tennessee, Knoxville). There are: (1) taxes that business

collects but doesn't necessarily pay like income taxes withheld from employees and sales taxes collected from customers, (2) general taxes that business customers pay along with everyone else like gasoline and general sales taxes, and (3) taxes paid only by business like corporate income and franchise taxes. Looking at taxes with an economic impact on business, Fox calculates that the largest burdens are property taxes on what business owns and then sales taxes on what business buys, followed by specific business taxes like income taxes on what business earns.

Taxing Business Versus Taxing Individuals: Public opinion polls continue to show a strong preference for taxing corporations rather than taxing people. This preference wasn't mirrored in the conference where several of the academics and consultants pointed out that corporate taxes actually have their impact (incidence) on individuals. As Fox put it, "Businesses don't pay taxes, people do." Several speakers mentioned a criterion for policy of avoiding taxes that were out of line with competitor states and nations.

Corporate Income Tax Collections: The unsatisfactory performance of corporate income tax collections was reviewed by Robert Aten (Manufacturers' Alliance for Productivity and Innovation) who assessed reasons for slower yield growth than other taxes. The principal reason is a decline in corporate profits relative to other aspects of the nation's economy. Aten gave a variety of reasons why corporate income tax payments would be erratic and suggested the phenomenon would continue. Dan Bucks (Multistate Tax Commission) suggested another difficulty: corporate income that isn't reached by taxes of any state. He called this an "ocean of nowhere income."

Assessing Business Tax Impacts: The multiplicity of taxes having an impact on business was the basis for Michael Vlaisavljevich to urge use of multi-tax models to simulate effects on business in general and on particular industries from tax changes being considered by state officials. He gave an example from work his firm (Price Waterhouse) did for a Florida commission. A study for Florida was also the basis for comments by Steven Waldhorn (SRI International) who stressed the importance of linking assessments of tax policy with state economic development objectives and strategies.

Value Added Taxes: State-level value added taxes continue to be taken seriously in conferences and by state study commissions, though Michigan's decades-old tax is the only example of one now in effect. NCSL's program devoted a whole segment to the subject. Bob Ebel (Peat Marwick) described the tax and its advantages. Robert McIntyre (Citizens for Tax Justice) was critical of the tax as having about the same regressive impacts as a sales tax.

Florida officials are searching for a way to continue to avoid a personal income tax while raising lots more money. The handout from Price Waterhouse showed the implications in Florida of replacing corporate income tax, the intangibles tax, and sales taxes on business purchases with a 2.4% tax on value added. While the gains and losses are

identical for business as a whole, they aren't for individual industries. Retail and wholesale sales and services see burdens rise by 95% and 69% respectively while burdens for other industries, such as manufacturing, drop dramatically.

Taxing Particular Industries: Some common situations and themes appeared in the panels that dealt with taxation of telecommunications, common carriers, and financial services. In all three, there has been rapid technological and organizational change that panelists agreed undermined the basis of traditional state taxing methods. In all three, the state response has varied in its speed and its substance. In all three, there is state concern over federal preemption of state taxing authority. In all three, the preemption concern is serious in part because the affected industries can make strong cases that the multiplicity of state procedures create difficult-to-justify administrative costs.

Not Taxing At All: While the conference was about tax policy, not budget policy, several speakers discussed the state fiscal environment -- often citing pressures to raise the overall level of state taxes and spending. Some mentioned "structural deficits," including Tarky Lombardi who chairs New York's Senate Finance Committee. But he complained that the aspect of curtailing spending rather than raising taxes is often neglected. Stephen Lemson (American Express) also urged looking at spending levels, eliminating waste, and setting priorities.

Conclusions: Such a conference inherently doesn't produce conclusions, but there were several points that can be inferred from what was discussed and what wasn't. First, panelists were not interested in shifting more of the state tax burden toward business. Second, they were hostile to tax concessions offered to particular firms to encourage them to locate or expand in a particular state. Third, they seemed more interested in sales taxes on business services and, in some cases, value added taxes than raising the rates of corporate income taxes. Fourth, business and state officials alike were uncomfortable with the situation in taxation of regulated industries like banking, trucking, and telecommunications.

Comparing Tax Burdens In Major Cities

Every year, the District of Columbia budget agency calculates the taxes that would be paid by citizens of the largest city in each state. The comparisons are available for various income levels. The one for a family with income of $75,000 is shown in Table 4. All major taxes are covered, including local property taxes which vary substantially among and within states, local sales taxes, and the local income taxes found in cities like Cleveland and New York. The income level of $75,000 is high enough so that income taxes play a major role in the comparisons, particularly in states with graduated income taxes like Oregon, Wisconsin, and New York. But other states have found ways to tap city families with this income level. Number four, Michigan, has a flat rate tax. In 1990, the year of the comparison, Connecticut hadn't yet adopted its income tax.

The city comparisons aren't valid proxies for state comparisons. For example, Pennsylvania has relatively low taxes by any comparison. But Philadelphia ranks seventh among major cities, in large part because of its wage tax which is over 4%.

Table 4: Estimated Tax Burden for a Family of Four, 1990
Annual Family Income of $75,000

Rank	City, State	Tax Burden	Rank	City, State	Tax Burden
1	Portland, Oregon	$11,484	26	Boston, Massachusetts	$7,435
2	Milwaukee, Wisconsin	11,474	27	Phoenix, Arizona	7,344
3	New York City, New York	10,608	28	New Orleans, Louisiana	6,986
4	Detroit, Michigan	9,570	29	St. Louis, Missouri	6,985
5	Bridgeport, Connecticut	8,982	30	Jackson, Mississippi	6,937
6	Portland, Maine	8,941	31	Oklahoma City, Oklahoma	6,875
7	Philadelphia, Pennsylvania	8,940	32	Albuquerque, New Mexico	6,839
8	Atlanta, Georgia	8,909	33	Billings, Montana	6,661
9	Providence, Rhode Island	8,885	34	Wichita, Kansas	6,641
10	Baltimore, Maryland	8,849	35	Chicago, Illinois	6,604
11	Newark, New Jersey	8,733	36	Charleston, West Virginia	6,499
12	Columbia, South Carolina	8,728	37	Indianapolis, Indiana	6,491
13	Omaha, Nebraska	8,530	38	Little Rock, Arkansas	6,399
14	Cleveland, Ohio	8,282	39	Wilmington, Delaware	6,214
15	Boise City, Idaho	8,267	40	Fargo, North Dakota	6,106
16	Des Moines, Iowa	8,261	41	Birmingham, Alabama	5,545
17	Minneapolis, Minnesota	8,179	42	Sioux Falls, South Dakota	5,487
18	Louisville, Kentucky	7,922	43	Seattle, Washington	5,473
19	Norfolk, Virginia	7,921	44	Manchester, New Hampshire	5,003
20	Denver, Colorado	7,892	45	Memphis, Tennessee	4,567
21	Salt Lake City, Utah	7,816	46	Houston, Texas	4,507
22	Honolulu, Hawaii	7,681	47	Las Vegas, Nevada	4,160
23	Burlington, Vermont	7,587	48	Anchorage, Alaska	4,063
24	Los Angeles, California	7,580	49	Jacksonville, Florida	4,038
25	Charlotte, North Carolina	7,531	50	Casper, Wyoming	3,277

MISCELLANY

Earmarked Revenues: Pennsylvania officials have dealt with one problem of earmarking revenues while setting up another. When the state lottery was created, funds were earmarked for the elderly. The lottery's rapid growth led to programs with few counterparts elsewhere, such as paying for prescription drugs outside of Medicare. Now lottery growth has slowed while the growth of the elderly population and drug prices remains rapid. So this year, some of the increase in the business franchise tax went to the lottery fund. The new earmarking is for transit. Rather than the regional sales tax used by many states, Pennsylvania will use a hodgepodge of state levies. One is a sales tax on

magazines. Retailers are complaining that they have no way to separate sales tax receipts on magazines from receipts on other items.

Curtailing Legislative Power: Now that the California Supreme Court has upheld the Proposition 140 voter initiative, the legislature must decide what to do about its restrictions on legislative staffing. The proposition mandates a cut of about 40% in legislative spending. Some reduction has already been taken by the offer of termination benefits made earlier this year. Now at issue are the legislative staff agencies, the auditor and the Legislative Analyst, the legislative fiscal staff. One option is apparently lodging one or both outside the legislative budget. The measure also limits House members to three two-year terms and Senators to two four-year terms.

TECHNICAL NOTES

Budget Data: Under fiscal pressure, states seem to have engaged in an unprecedented degree of creative budgeting this year. This makes the survey data somewhat unreliable, though useful as the only information available. The data are reliable as indicators of what is in the announced state budgets. But the projections are unreliable if used on the assumption that comparable reporting practices are being followed in all states. These concerns aren't unique to **Reports**, they are extensively aired in the NCSL report.

The changes in appropriations shown in the chart on p. 6 illustrate the problem. **Reports** compared the appropriation for FY 1991, as reported by NCSL last fall and the estimated spending for FY 1991 as reported this fall. The elementary and secondary education cuts appear to be dominated by reductions of 24% in Florida and 19% in Indiana. These aren't representative of real cuts in state aid but are likely to reflect: (1) shifting of funding by a matter of weeks to get costs out of one fiscal year and into another and (2) use of funds other than the general fund to defray state obligations to school districts.

There are similar problems with other programs. The shift from FY 1990 spending to FY 1991 AFDC spending estimated this year was -35% in New Jersey and 56% in North Carolina. Budgeted increases for FY 1992 ranged from 39% in Nevada to -15% in Ohio and -16% in North Dakota. In NASBO's latest spending report the changes from FY 1990 to FY 1991 are less varied, but still varied. For example, the AFDC changes are bracketed by increases of 40% in New Hampshire to cuts of 28% in North Carolina.

The full citations of reports relied on in this issue are State Expenditure Report: 1991 (the NASBO spending report), State Budget And Tax Actions: 1990. (NCSL's fiscal survey), Fiscal Survey Of The States: October, 1991 (NASBO's fiscal survey), and Tax Rates And Tax Burdens In The District Of Columbia: A Nationwide Comparison (District of Columbia Department of Finance and Revenue, 300 Indiana Ave., NW, Washington, DC 20001).

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IN THIS ISSUE

Many states are now immersed in another round of mid-year budget cutting while anticipating a tight budget next year. Repeating one-time fiscal fixes is inherently difficult. Tax increases aren't attractive. So interest grows in how to downsize state governments.

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The choices for budget cutting are illustrated by a report on ideas for cuts in Massachusetts, a long list of cuts being considered in Maine, and the work of a task force in Iowa.

• Strategies In Three States p. 8

Higher education was the loser in recent state budget battles, but did better in some states than others, with patterns that could be repeated. Large state tax increases didn't guarantee generous higher education budgets.

• Higher Education Finance p. 13

With finances tight, maintaining funding for other programs while avoiding tax increases means finding ways to control Medicaid costs. So far, getting the federal government to pay more is about all that has worked. New hazards for state budgets are developing from the interaction of federal restrictions on bootstrap financing and litigation on rates paid providers of Medicaid services.

• Financing Health Care p. 16

Miscellany covers borrowing without creating debt, economic pump priming by state policies, off-budget taxes and state business climates, and the latest look at how state and local finances are responding to recession. Technical notes detail sources and calculations.

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BUDGET CUT STRATEGIES

Introduction

Unless the economy turns around suddenly, and we're not seeing those indications, this is going to be a difficult year.

This recent comment on California's situation by the Legislative Analyst (legislative budget officer) applies to most of the states. Results through October suggest they have experienced all or some of a list of bad fiscal news:

- Results in FY 1991 were worse than anticipated when the FY 1992 budget was enacted, so balances brought into the new year were lower than expected.
- Tax collections during the first third of FY 1992 have been below expectations.
- Because of the collections experience in the early part of the year and lowered expectations of national and state economic forecasters, revenue estimates for the remainder of the year are being reduced.
- Practically nothing is costing less than the amount appropriated for it, but many big-ticket programs, particularly Medicaid, are costing more.

As a result, the search is on again for ways to close state budget gaps.

In many states, this will be a different search than in late 1990 and the first half of 1991. The new search is likely to put more stress on permanent reductions in state spending patterns. Spending cut choices look comparatively more attractive because there is, for now at least, a stronger-than-usual aversion to tax increases.

Avoiding both painful spending cuts and painful tax increases by the one-time methods of balancing budgets -- running down balances, using Rainy Day funds, accelerating revenue, and postponing spending -- is clearly the most attractive alternative to many state officials. These options were used in the pre-election environment of 1990 in many states. They were used extensively again this year to try to retain balance in FY 1991 budgets while revenues fell below estimates and to balance FY 1992 budgets.

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This heavy use in 1990 and 1991 results in two handicaps as state officials now try to deal with FY 1992 shortfalls and FY 1993 budgets. First, the most attractive measures have already been used. Balances can't be drawn down twice. Assets can't be sold twice. By definition, one-time measures can't be used again. Second, the previous extensive use of one-time measures now exacerbates the fiscal problem. New revenues in FY 1993 must first cover spending financed with one-time revenues in FY 1992 and then cover growth in spending.

Avoiding Tax Increases

I find no sentiment anywhere for a tax increase.

This was Governor Schaefer's comment after attending a November meeting with Maryland legislative leaders about a shortfall that may require cutting some $850 million over the next 18 months, a large chunk of the $11-12 billion in spending. Last year Schaefer pushed a tax increase. He might do so again, but not until it appears that spending cuts are unacceptable.

... if there were easier choices, we would have made them.

This was how the governor's press secretary defended the $122 million package of cuts recently proposed to rebalance the FY 1992 Maine budget which is now viewed as 3-4% out of balance. He was suggesting that the legislative majority (D) had little choice but to accept the general thrust of the cuts proposed by Governor McKernan (R). As in many states, leaders are assuming that tax increases aren't a viable option.

The truth is, while California's tax burden is still lower than some of our competitors, it has reached the highest level we can tolerate. As we work to close a budget gap in the year ahead, it will be closed through spending cuts, not tax hikes.

This was what Governor Wilson told a business audience in November after learning that October revenues were nearly $200 million below the forecast. Combined with shortfalls in previous months and known spending overruns, the disappointing revenue figure suggested a high probability that the state's budget is far from balanced. The major tax increases adopted earlier this year are not proving enough to salvage the situation.

Part of California's problem is like that of other states. The recession apparently didn't end on schedule. Another part of the problem is that California's economy doesn't appear to be outgrowing the national economy as it did through the 1980s.

According to the Commission on State Finance, California's budget gap (defined as the shortfalls in the current year plus those in the new budget year) looks close to $6 billion. The action earlier this year was designed to close a gap of $14 billion. The total California budget (all funds) is about $56 billion.

Many Factors Discourage Tax Increases

Raising taxes and cutting spending can be seen as competing ways to balance state budgets. Raising taxes always starts as the underdog. Public opinion clearly favors cutting budgets which the public believes are excessive. Public opinion favors cutting, not raising, taxes. Elected officials of both parties have with few exceptions campaigned on the basis of their ability and determination to control spending and avoid tax increases. So it isn't surprising that this fall, like others before, most elected officials are talking about ways to cut spending and assuring the electorate that tax increases aren't on the table.

In addition to all the normal problems with tax increases, there are some special factors affecting their acceptability in 1992. The first is that many elected officials have already been to the tax increase well. Over the past three years there have been cumulative tax increases of more than 10% in 21 states. The second is that in most states this is an election year, a time when elected officials are least enthusiastic about raising taxes.

Third, it is a year when the media apparently will be filled with discussion of possible national tax cuts, and thus of arguments why taxes should be cut, not why they should be increased. Fourth, early 1992 appears likely to be a period of economic hard times. So tax increases can be characterized as hurting the taxpayers when they can least afford it. A sophisticated version of the same argument is that tax increases pull purchasing power out of the economy when government should be stimulating purchasing power by putting money into it, or at least remaining neutral.

Tax Increases Over Three Years

Mirror, mirror on the wall. What states raised taxes most of all?

As legislators and governors of many states prepare for reelection in 1992 and a few governors seek the Presidency, there is likely to be considerable interest in their records on budgets and taxes. Objective quantitative comparisons aren't easy to make as **Reports** discovered upon being quizzed at length recently by Erik Kriss of the Syracuse Herald-Journal, who is surely but the first in line with such questions.

The concern with recent tax increases isn't necessarily the right concern. The history of recent *increases* says nothing about the *levels* or *burdens* of taxes, which depend upon the starting points as well as the changes. Looking at legislated increases leaves out

automatic revenue increases which are much greater in some states than others. Finally, looking at state taxes leaves out state action that encourages local tax increases.

Past tax increases can be a significant factor in state fiscal strategies. Legislators and the public aren't as likely to accept increases in states which have had several large increases in recent years as they are in states which have had no significant recent increases. So tax increases are clearly ruled out in states such as Connecticut and Pennsylvania. They are more a possibility in states with no major increases in three years such as Alabama, Idaho, Indiana, Utah, and Virginia. In some states, there has been considerable discussion of increases, but no increases. Examples are Colorado, Kansas, and Mississippi.

Table 1 was developed from previously reported tax increases -- See Technical Notes for details. It shows the percentage by which state tax revenues have been increased as a result of legislation enacted in 1989, 1990, and 1991.

Table 1: Tax Increases Enacted 1989-1991 As Percent of Tax Revenues

Rank	State	Percent	Rank	State	Percent	Rank	State	Percent
1	Connecticut	34.4%	18	Maine	11.6%	34	Colorado	2.6%
2	Nevada	22.6	19	North Carolina	11.3	35	Maryland	1.7
3	Vermont	22.1	20	Illinois	11.0	36	Alabama	1.5
4	Pennsylvania	21.5	21	Missouri*	10.3	37	Wyoming	1.4
5	New Jersey	21.0	22	Delaware	9.5	38	Idaho	1.3
6	Rhode Island	20.7	23	Tennessee	8.9	39	South Carolina	1.3
7	Alaska	18.8		**United States**	**8.8**	40	Mississippi	0.8
8	West Virginia	18.8	24	Texas	8.2	41	Louisiana	0.7
9	Nebraska	18.2	25	Montana	8.1	42	Kansas	0.4
10	Massachusetts	17.1	26	Arizona	7.9	43	Iowa	0.2
11	Arkansas	14.8	27	Oklahoma	6.2	44	Michigan	0.0
12	Kentucky	14.5	28	Oregon	6.2	45	Utah	-0.2
13	North Dakota*	13.2	29	New Mexico	5.1	46	South Dakota	-0.4
14	California	12.3	30	Minnesota	4.9	47	Virginia	-0.7
15	New Hampshire	12.2	31	New York	3.8	48	Indiana	-1.5
16	Georgia	11.9	32	Washington	3.6	49	Wisconsin	-2.9
17	Florida	11.8	33	Ohio	3.0	50	Hawaii	-11.0

Only one state, Hawaii, made major tax reductions during the three years. Hawaii's economy was extremely prosperous during the late 1980s. The state gets much of its revenue from a steeply graduated income tax not indexed for inflation so revenue growth tends to be substantially greater than economic growth. Five other states show reductions. They generally represent minor adjustments (e.g., dealing with the Davis case on taxing pension income) rather than across-the-board attempts to reduce state tax burdens.

Forty-three states raised taxes during the three years. The largest increases were in the Northeast, particularly New England. These states experienced the economic downturn before it affected the rest of the nation and have continued to suffer more than other states.

Most of the tax increases have had the effect of financing state operations even though some were sold at the time as being primarily for something specific, usually education. A few were large enough or earmarked enough so that all or part of them can be considered as designed to lower property taxes or prevent property tax increases that would otherwise have taken place. Because this use of funds -- raising one tax to lower another -- is more acceptable than higher spending, officials of many states claim this result. The increases most closely tied to lowering property taxes are those in New Jersey, Nebraska, and Oklahoma.

The Emphasis On Budget Cuts

With tax increases ruled out, at least for now, and widening budget gaps appearing, many states are again looking at how to cut budgets. In some, the issue is mid-course corrections required to keep this year's budget in balance, with Florida, Georgia, and Maine good examples. In some, the issue is the FY 1993 budget which appears to have a gap that elected officials would rather close by spending cuts than tax hikes. In some, such as Mississippi and New Jersey, the issues arise because new leaders were recently elected with pledges to cut the budget.

Changing The Nature Of Cuts

Some of the state budget decisions of 1991 reflected a determination to bring long-term spending and revenue into balance. California is a good example. Besides raising taxes, the state ended its automatic escalation of AFDC benefits, altered some features of its pension system, and revised its fiscal and programmatic relationships with counties in health and welfare. Pennsylvania settled on long-term funding for Philadelphia area transit, set up new financing arrangements for Philadelphia, and revised its relationship with local governments in funding child welfare.

Many of the budget decisions of 1990 and 1991 didn't reflect long-term decisions like these. Instead they featured one-time revenues, one-time expenditure reductions, and deferrals of costs into future years. They often included freezes of travel, pay, and/or equipment purchases that aren't tenable in the long run. Even in California, the process of developing long-term budget balance was incomplete. Some of the tax increases are temporary. Proposition 98's built-in increases in education remain, and thus some structural deficit probably remains also.

New Looks At Long-Term Budget Balance

With shortfalls appearing again, officials of some states will be shifting their attention toward more permanent budget cuts. This will particularly be true in those states that have structural deficits, built-in imbalance between outlays to maintain current services and revenues from existing taxes.

Structural imbalance depends upon the observer's view of what spending is needed to maintain current services. In projecting budgets, officials of some states will include outlays such as those required to fund increasing costs of a multi-year education quality plan while officials of other states don't include such outlays. Some include inflation adjustments for employee pay and cash assistance for welfare recipients. Some don't. So no national list of states with structural imbalances can reasonably be constructed.

From a national perspective, revenue systems will have much to do with the long term outlook. A revenue system that won't likely keep pace with personal income is likely to be associated with imbalance. Examples are the sales-tax-dominated revenue systems of Florida, Tennessee, and Texas and the excise-tax-dominated revenue system in New Hampshire. By indexing its income tax for inflation, California also limits its automatic revenue growth. By contrast, tax systems of Ohio, New Jersey, Minnesota, and especially Hawaii capture economic growth and then some. Capturing economic growth is of little value if there isn't much growth to capture, so the outlook in West Virginia and the Northeast is less sanguine than in, say, Idaho or Texas.

Spending factors also affect the outlook. Florida's and California's education cost problems are inherently worse than those of New York because the two sunshine states are experiencing sharp growth in public school enrollment and in the age group that creates the demand for spaces in community colleges and universities. The combination of demographics and the phasing in of federal AFDC and Medicaid mandates gives Southern state budgets an upward thrust not matched elsewhere.

Long-term looks at whether structural imbalance exists and what to do about it are discouraged by state budget procedures that call for balance to be restored in the current fiscal year and don't require balance over an extended period.

In New York, there is serious discussion of combining the shortfall problem for the remainder of FY 1992 (which ends in the spring) with the problem expected in FY 1993. Controversy is bound to develop. The combination can be viewed as the good management practice of taking a longer view of budget balance. But it can also be viewed as just a way to roll the current year deficit into a future fiscal year without solving it.

STRATEGIES IN THREE STATES

Every state has many mechanisms for generating ideas for budget cutting. The players extend beyond executive budget offices and legislative fiscal staffs to task forces and think tanks. Three states -- Maine, Massachusetts, and Iowa -- illustrate what is happening.

Assessing Options In Maine

The Upward Spending Thrust: Maine officials are under considerable pressure to cut spending. With coffers flush from New England prosperity of the late 1980s and expectations high, they adopted many expensive new initiatives including state-funded property tax relief and initial steps toward a state-funded universal health program.

Facing Reality In 1991: By the election of 1990, the affordability of such programs was an issue. Incumbent Governor McKernan contended some spending cutbacks would be appropriate but that tax increases weren't necessary. His opponent claimed the situation was worse than the governor was admitting. By early this year, the governor, who was reelected, had endorsed a tax increase. By the end of the session, it became one of the largest tax increases in the nation and was combined with cuts in state aid that tended to stimulate local tax increases as well. The session was a bitter one that ran well beyond the beginning of the fiscal year and involved various closings of state operations.

More Shortfalls Develop: It now appears that these steps weren't enough. A shortfall of about 3% of the current budget is anticipated to result from revenue shortfalls and some spending overruns. There is general agreement that adjustment should be made by spending cuts rather than another tax increase. Furthermore, there appears to be agreement that the problem is not temporary. As a result, one-time revenue items and temporary furloughs are likely to be less favored while permanent changes such as eliminating programs will be more favored.

Ideas For Budget Cutting: As state officials held public hearings around the state on the options, attention concentrated on a dozen concepts:

(1) reduce the revenue sharing program which provides about 5% of all sales and income tax revenue to local government,

(2) cut school aid across the board and/or reduce the portion of administrators' salaries covered in the foundation formula,

(3) tighten welfare by curtailing the general assistance program and imposing stiffer work requirements in AFDC,

(4) eliminate the demonstration health insurance program,

(5) reduce compensation of state employees who recently got 7% raises under a three-year agreement dating from more prosperous times by (a) salary cuts and (b) requiring a larger employee share of health insurance costs,

(6) cut tax relief provided for excessive property tax burdens under the circuit breaker program,

(7) require co-payment in some social service programs,

(8) curtail some special state activities that are much more extensive and expensive than in other states -- in Maine this means land use and growth management,

(9) privatize state liquor stores and contract out operation of the lottery,

(10) consolidate some higher education campuses and state offices in rural areas,

(11) reconsider some of the sentencing practices that are increasing prison populations, and

(12) downsize the state Department of Education.

The list resembles similar lists being considered in other states. The items on it are not new. Most have been considered and rejected in the past. The question is not whether anyone has new ideas for spending less but whether the Maine climate for consideration of such ideas has changed.

Relaxing Mandates: One aspect of the proposals in Maine is a willingness to relax state mandates to relieve some of the fiscal pressures state aid cuts will put on local government finances. This concept was a prominent feature of aid cut discussions earlier this year in the Massachusetts and New York legislatures and probably elsewhere.

Assessing Options In Massachusetts

> *Pioneer Institute's competition to encourage innovative thinking about state government has produced a bumper crop of well thought-out ideas. Everyone interested in state government will gain from reading* Invitation To Change

These words of praise from Governor Weld provided a stamp of approval for the published results of an innovative effort by Pioneer Institute, a Boston-based think tank. Massachusetts citizens were asked to make suggestions for improving state government, given time and a little money to perfect the suggestions, and given space in Invitation To Change to write up their suggestions. The results are summarized below.

Privatizing: Getting more money out of state authorities (transit, wastewater treatment, airport, turnpike, etc.) was a feature of Bay State budget-balancing proposals in

the late 1980's. Change suggests selling Logan Airport to realize about $400 million and improve service. Another suggestion is to lease unused state land in Boston as parking lots.

State Representative John Bradford contributed a detailed suggestion that volunteer services be used to handle home care for the elderly that the state can't afford. Volunteers would accrue credits entitling them to services of other volunteers should they need them later. The suggestion is modeled on an apparently successful program in Missouri. Linking business volunteers and state economic development efforts was also suggested -- a concept sounding much like the Minnesota Business Partnership and parallel ideas in other states.

In purchasing day care services, one suggestion is to move to a voucher plan. Contracting out is suggested for pharmacies in state institutions and collecting child support payments.

New Financing Methods: The suggestion by Morgan Stanley & Co. for Boston-area transit deals with the $450 million annual subsidy resulting from the state paying a larger share than other states pay for transit costs. The subsidy has grown 70% in four years because there appears no other place to look for money. Fares aren't increased more than they have been out of fear of driving riders away. Local share hasn't been increased because of fiscal problems of local government and the state-imposed limits on local property taxes. Federal spending has been limited by federal policy choices. The major policy recommendation is to raise more money by using a dedicated revenue source from the area served such as a regional sales tax or auto registration fees.

Improved Management: One difficulty constantly encountered in using management improvement recommendations to save money is that the recommended improvements often mean spending more, not less, in the budget under review. The payoffs tend to be hard to measure as they take the form of unenforceable promises of lower future costs or unmeasurable promises of improved services. The suggestions from Ernst & Young for Bay State vehicles provide an illustration. The immediate costs are developing a better information system, increasing preventive maintenance, and more purchases of new vehicles to replace old ones that presumably are in stock because equipment purchases have been deferred. Immediate savings would, however, result from following the suggestion that fewer employees be given state vehicles for commuting.

The proposals for tightening enforcement of Medicaid rules against those who conceal assets before or while getting Medicaid payment for nursing home costs also involves immediate costs, though the savings are potentially dramatic.

Unintended Or Misunderstood Consequences: The Pioneer report includes two items under "works in progress," both illustrating costs of other policies. The first concerns early retirement options for employees offered to: (a) induce retirement or (b) compensate employees involuntarily terminated for fiscal reasons. In Massachusetts, the lifetime benefit

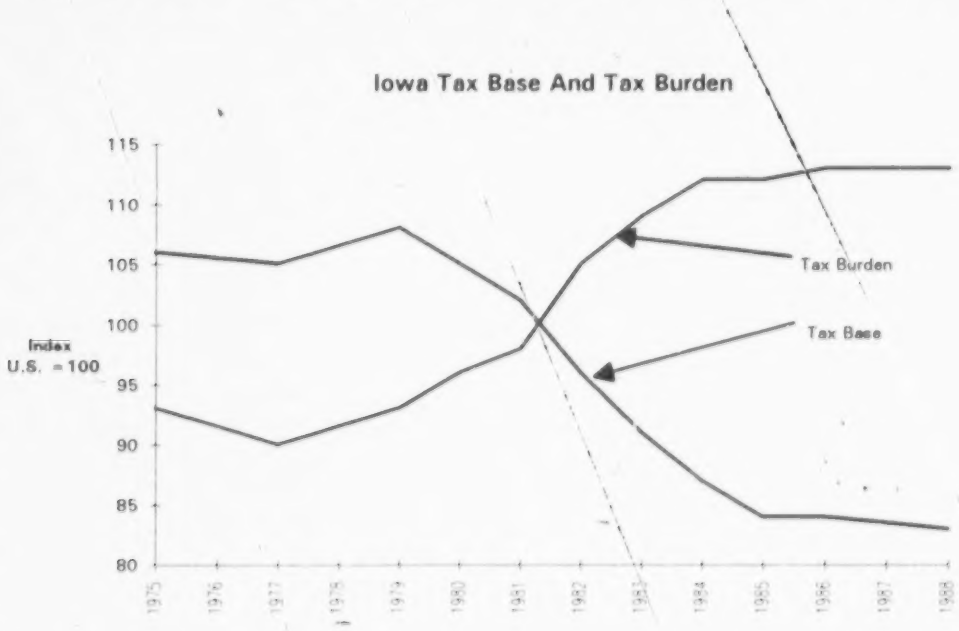
from early retirement costs more than twice a regular retirement. The second concerns the projections for the "uncompensated (health) care pool" that were made when the state passed universal care legislation in 1988. Those costs were expected to decline through initial universal care policies (mostly not implemented) and various cost-saving measures (not implemented). The pool now costs the private sector over $340 million a year.

Downsizing In Iowa

Adversity is a great educator.

This is part of the rhetoric used by business executive David Fisher, who chairs a governor's efficiency task force, as he talks up the need to consider Iowa government practices with, as he puts it, "no sacred cows."

Shrinking The Economy Without Shrinking Government: Much of Iowa's problem stems from a failure to change state and local policy to reflect the state's changing demographic and economic circumstances. The state had an above average economic base and was able to sustain above average spending with below average tax burdens. As the economic base deteriorated relative to the rest of the country, the patterns of government spending were maintained, leading to higher-than-average tax burdens.



The graph tells the simple story. As Iowa's tax base dropped from above average to below average its tax burdens rose from below average to above average.

Coming To Grips With The Problem: The problem was put dramatically by the editors of the state's major newspaper (Des Moines Register, October 27):

> *Personal income in Iowa stopped growing on pace with the national average. Poverty has risen to distressing levels. Over time, those trends will be devastating. An Iowa that is slipping farther and farther behind the rest of the nation will not be able to maintain its outstanding schools, its fine universities, its level of public services.*
>
> *Already it has begun. State government leaders are convinced that Iowa has more government than its people can afford, but there is no agreement on what to eliminate or how.*

The governor, a significant number of legislators, and much of the population don't want to consider increasing state or local tax burdens. To this end, the task force is considering ideas comparable to those being considered in other states.

Privatization: The state has already gotten out of the retail liquor business, the first state to do so since 17 states decided to run liquor stores when Prohibition ended. Consideration is now being given to eliminating prison farms, selling state-owned recreational facilities, such as a golf course, selling the state TV station, and using contractors more and state employees less.

Standard Budget Cuts: The usual range of budget cut options are being considered. Closing one or more large mental hospitals is a possibility. So is eliminating some programs in higher educational institutions, but not closing institutions.

Local Government Reforms: Iowa has seen a massive redistribution of population. Rural areas, excepting a few growth centers, have lost population while metropolitan areas have seen gains. Governmental institutions and state policies haven't shifted as fast as people. For example, the distribution of state highway and road money puts more money into rural areas than traffic would suggest. The school aid program has elements favoring rural districts, although Iowa no longer gives aid for "phantom pupils." These were pupils counted in the per pupil aid formula who would have been attending school if each district had maintained its past enrollment levels.

Ideas now under relatively serious consideration include consolidation of the 425 school districts and perhaps even consolidation of some county governments. Consolidation of the judicial system is also being discussed. Reducing the state's outlays for property tax relief through homestead and farmland credits is also under discussion. Such a move would make property taxes more expensive for taxpayers and presumably increase resistance to unnecessary local government costs.

HIGHER EDUCATION FINANCE

Higher Education Feels The Pinch

Higher education hasn't fared well in the tough fiscal environment of the last several years. Table 2 shows the annual average of the two-year change in state funds for higher education from FY 1990 to FY 1992. It is a measure of support from state dollars, uniformly excluding tuition and federal revenues even though some states include one or both in their budgets.

Table 2: Annual Change In State Higher Education Support, FY 1990-FY 1992

Rank	State	Percent	Rank	State	Percent	Rank	State	Percent
1	Nevada	15.5%	18	Michigan	4.5%	34	Ohio	1.0%
2	Idaho	12.0	19	New Hampshire	4.5	35	Alaska	0.5
3	Kentucky	11.5	20	Utah	4.5	36	Illinois	0.5
4	Montana	10.5	21	Wisconsin	4.5	37	New Jersey	0.5
5	Arkansas	10.0	22	Maine	4.0	38	Georgia	-0.5
6	Oklahoma	10.0	23	Pennsylvania	4.0	39	North Carolina	-0.5
7	New Mexico	9.0	24	Texas	4.0	40	Connecticut	-1.0
8	Oregon	9.0	25	Wyoming	4.0	41	Maryland	-1.0
9	Nebraska	8.0	26	Iowa	3.5	42	Missouri	-1.0
10	Hawaii	7.5	27	Delaware	2.5	43	Tennessee	-1.0
11	South Dakota	6.5	28	Minnesota	2.5	44	Vermont	-1.5
12	Washington	6.5	29	Colorado	2.0	45	Florida	-2.5
13	North Dakota	6.0	30	South Carolina	2.0	46	Mississippi	-2.5
14	Indiana	5.5		**United States**	**1.5**	47	Virginia	-2.5
15	Arizona	5.0	31	California	1.5	48	New York	-6.5
16	West Virginia	5.0	32	Kansas	1.5	49	Rhode Island	-8.5
17	Louisiana	4.5	33	Alabama	1.0	50	Massachusetts	-14.0

Probably the most striking aspect of Table 2 is the large number of negative numbers it shows. About a fourth of the states cut their higher education support in nominal dollars, that is even before considering inflation. After discounting increases for inflation, half to two-thirds (depending on the inflation measure used) of the states cut university budgets. These results aren't just one year of grim fiscal circumstances, they are half of two years of change. So they represent a two-year slice suggestive of the budget outlook for much of the 1990s.

Examining which states raised support most and least is suggestive of tight times for higher education in many circumstances. The states in the top ten, with a 7.5% increase or more, involved combinations of these factors: (1) extraordinary enrollment growth as in Nevada and Idaho, (2) relatively prosperous state economies as in Hawaii, Idaho, and Oregon, and/or (3) tax increases sold on the basis of education spending as in Arkansas,

Kentucky, and Oklahoma. These combinations are found predominantly in less populous states, which is why the national average is lower than 30 states.

Many of the states which raised taxes substantially (see Table 1) decreased higher education support at the same time. Examples are Connecticut, Illinois, Massachusetts, New Jersey, North Carolina, Rhode Island, and Vermont. Their new money went to balancing the state budget or to balancing plus some objective other than higher education such as local aid in Illinois and public schools plus property tax relief in New Jersey.

Higher Education Losing "Its Share" Of State Budgets

Table 2 suggests that these have been tight times for public higher education, but then these have been tight times for states and thus for other state programs as well. So higher education may just be sharing in the general fiscal misery. If true, this would suggest that state university officials need only adjust to temporary adversity while awaiting the budget bonanza that will inevitably follow from national economic recovery and the ensuing generous state budgets.

Table 3 suggests this assumption isn't true. It contrasts the percentage increase in each state's higher education budget with the corresponding increase in its total general revenue fund (GRF) budget. The difference is the edge that higher education enjoyed over other state programs.

> The numbers in Table 3 don't correspond to those in Table 2. The years are different, FY 1990-1992 in the first and FY 1991-1992 in the second. Also, as detailed in Technical Notes, Table 2 reflects what higher education administrators stress on a nationally uniform basis while Table 3 is from summary totals legislators use when explaining what they did in appropriations bills.

That edge is -2.7%. Higher education appropriations are up 2.2%, considerably less than the 4.9% increase in general fund appropriations. That spread will increase as the year progresses. Universities and community colleges have set their spending patterns for the 1991-1992 academic year and generally won't exceed them. So there won't be substantial supplemental appropriations for them just as there won't be for public schools. But there will be large supplemental appropriations for other programs, particularly Medicaid. So through the year, the general fund increase may rise while the education increase doesn't.

Increases in state taxes didn't necessarily help higher education much. In California, higher education appropriations were reduced as taxes were raised nearly $7 billion. Two of the largest percentage increases in the nation were in Connecticut, where higher education rose 1.2%, and Pennsylvania, where higher education rose 4.5%.

Table 3: Percentage Increases In Higher Education and General Funds, FY 1992

Rank	State	Percent Increase H. Ed.	GRF	Diff.	Rank	State	Percent Increase H. Ed.	GRF	Diff.
1	Nevada	17.1%	7.1%	10.0%	26	West Virginia	2.1%	4.5%	-2.4%
2	North Dakota	13.4	12.9	0.5	27	Wisconsin	2.0	4.6	-2.6
3	Kentucky	12.7	10.1	2.6	28	Arkansas	1.9	4.9	-3.0
4	Montana	11.3	11.3	0.0	29	Ohio	1.5	4.5	-3.0
5	Oklahoma	10.3	4.4	5.9	30	Iowa	1.4	4.3	-2.9
6	Maine	10.2	1.6	8.6	31	Connecticut	1.2	5.2	-4.0
7	Hawaii	8.4	-1.1	9.5	32	Kansas	0.8	1.1	-0.3
8	Oregon	8.3	8.3	0.0	33	New Jersey	0.2	18.3	-18.1
9	New York	7.5	-1.6	9.1	34	Delaware	0.1	3.7	-3.6
10	South Dakota	7.2	6.8	0.4	35	Wyoming	0.0	0.0	0.0
11	Idaho	6.1	7.3	-1.2	36	Florida	0.0	11.1	-11.1
12	Michigan	5.2	-0.8	6.0	37	South Carolina	-0.3	2.9	-3.2
13	Utah	4.7	4.0	0.7	38	California	-0.4	7.0	-7.4
14	Pennsylvania	4.5	12.3	-7.8	39	Vermont	-0.5	3.7	-4.2
15	Alabama	4.5	-2.6	7.1	40	Illinois	-0.8	7.8	-8.6
16	Washington	4.0	8.5	-4.5	41	North Carolina	-0.9	3.7	-4.6
17	Colorado	3.9	3.3	0.6	42	Maryland	-1.2	4.8	-6.0
18	Georgia	3.8	-1.0	4.8	43	Alaska	-1.3	-0.2	-1.1
19	New Mexico	3.7	6.3	-2.6	44	Minnesota	-1.5	-6.0	4.5
20	Nebraska	3.3	3.6	-0.3	45	Tennessee	-1.9	0.8	-2.7
21	Indiana	3.2	0.2	3.0	46	Mississippi	-2.1	2.8	-4.9
22	Texas	3.1	12.0	-8.9	47	Louisiana	-3.6	0.1	-3.7
23	New Hampshire	2.9	13.0	-10.1	48	Virginia	-3.9	-4.3	0.4
24	Missouri	2.5	1.2	1.3	49	Rhode Island	-8.2	1.6	-9.8
25	Arizona	2.2	4.4	-2.2		Massachusetts	No Data		
	United States	**2.2**	**4.9**	**-2.7**					

When the rest of state budgets rise faster than budgets for higher education, the share of state budgets going to higher education will shrink. This creates some interest in mechanisms that would preserve a past year's share. This is what California's Proposition 98 does for elementary and secondary education, defined to include community colleges. One result is shown on Table 3. In California universities have been squeezed between growing shares for corrections and Medicaid and a constant share for public schools.

There doesn't seem to be much activity to define a constant higher education share. In some states higher education interests have focused on increasing the size of the budget pie, rather than maintaining the relative size of their slice. The Missouri tax increase rejected by voters in November reflected this perspective, with nearly half the new money destined for higher education.

FINANCING HEATH CARE

It's going to be the issue of the 90's in this country, and it will be the issue of 1992 in New Jersey.

With this comment, Governor Florio announced he would concentrate on health care in the next legislative session. As in many states, doing anything with a substantial impact will be difficult.

State Health Care Initiatives

There is no shortage of proposals for state action on health care. Most states, including New Jersey, have had blue ribbon commissions examine the subject and make recommendations. Those recommendations usually call for extracting large sums of new money from three players: (1) private employers through mandates of coverage or payment (pay or play) and, in New Jersey's case, additional taxes, (2) the state through more extensive Medicaid coverage, tax credits for private insurance, and state administration of new plans, and (3) the federal government through its share of Medicaid expansion.

The problem is that most states aren't in a position to put up additional resources. New Jersey is a fine example. The FY 1992 budget was balanced only by one-time items like selling state assets and advancing tax collections from utilities. Although nothing official has been announced, the FY 1993 budget is likely to be way out of balance, something like 5% of spending on a current service basis. No one is talking about raising taxes. Republican legislators, who have veto-proof majorities as a result of the November elections, are talking about repealing one cent of the sales tax. Under those circumstances, funding the Garden State's existing health care programs will be difficult.

This will concentrate attention on off-budget financing, such as the roughly 20% surcharge the state already places on hospital bills to cover costs of uncompensated care. This is an unpopular plan. Its renewal last year overcame opposition from those wanting more, and those wanting less, state involvement. Ultimately, they found they couldn't agree on anything else, so they renewed the plan. A similar battle could occur this year.

Despite fiscal problems, there will be consideration of plans in some states. For example, Governor Carlson is pushing a plan in Minnesota that would use funds from a steep cigarette tax hike to subsidize care for low-income families and the self-employed.

In Massachusetts, the major current issue is the effort to deregulate hospital rates and limit cross-subsidies for uncompensated care. The governor argues that competition will encourage efficiency. Hospitals serving a large proportion of non-paying patients claim it will drive them out of business. The Senate cochairman of the joint committee dealing with the bill used stinging language to explain his unexpected support, "I favor putting the

scorpions in the same bottle -- the Beth Israels {hospitals}, the HMOs, and the rest -- and letting them fight it out."

Possible Compromise On Bootstrap Financing

A tentative compromise between the Bush Administration and representatives of the states has apparently been reached on Medicaid bootstrap financing. There are many hurdles to be jumped before any compromise becomes final. So there will be uncertainty as the governors develop their final budget recommendations. They are likely to presume the continued availability of existing arrangements or close substitutes for them.

The close substitutes may generate the most controversy. Many states will be needing money as a substitute for donations and certain provider taxes that will be ruled out by the agreement. They will also be looking for money to fund rapid growth in Medicaid spending. But they will be looking to avoid "new taxes." This could generate interest in special gross receipts taxes on prescription drug sales and gross receipts of nursing homes, hospitals, and perhaps physicians. Interest could be particularly great in states where such levies wouldn't provide money for the general fund and arguably wouldn't be classified as new general taxes.

Whether this politically desirable result occurs largely depends on the providers. In cases where providers oppose such levies, as has been the case in Florida, they are labeled a "sick tax" and the opposition campaign makes it impossible to enact them quietly. But some of the provider taxes supported by providers have been enacted quietly. As indicated by their omission by some states in the NASBO and NCSL fiscal surveys, these haven't all been treated as new taxes.

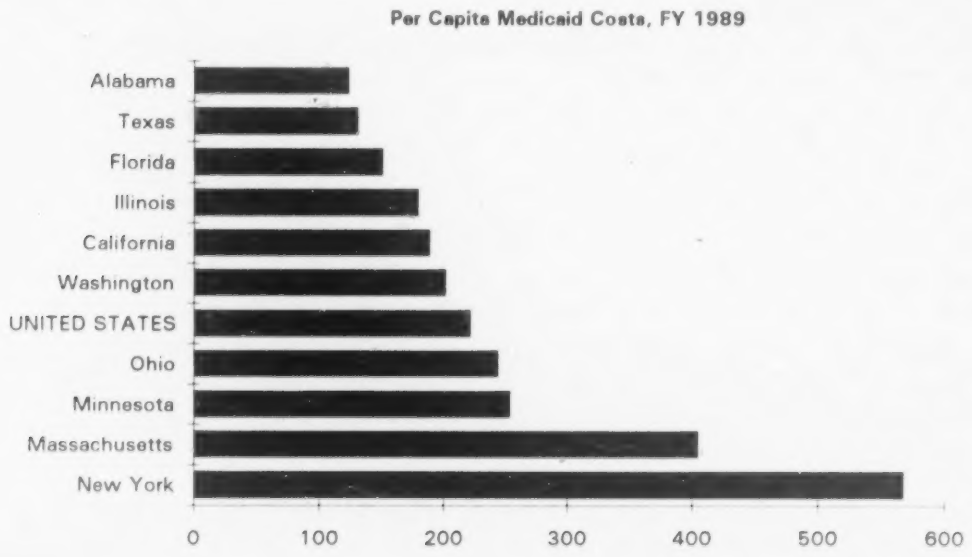
Getting In On The Action

New Hampshire's legislature met in special session in November to solve its budget shortfall problem without cutting services or raising unpopular taxes. Using bootstrap financing was so generally acceptable that the session took only one day. The result is viewed locally as a revenue infusion of about $115 million, solving a budget gap of about $100 million. This is gap-closing of $100 per capita. If all states duplicated the Granite State action with the same per capita results, their gain would be about $25 billion. That is almost twice all the money raised by all the state general fund tax increases this year.

What Makes Medicaid So Expensive?

Faced with consequences of spending rising at 15-25% a year, state officials are constantly asking whether Medicaid costs too much and what might be done to control costs. One way to address this question is to examine the components of costs and the factors, such as health care price increases and changes in numbers of recipients, that drive

the changes in overall Medicaid budgets, as is done periodically in **Reports**. Another approach is to compare costs among states and see why some states spend much less than others. The chart suggests that there is considerable difference to be explained.



The chart suggests that New York could cut its Medicaid spending in half by just conforming its policies to the national average, that the average state could realize substantial savings by moving to the policies of Illinois or even California, and that practically all states could cut costs by following the policies of Alabama or Texas. As part of a recent assessment of possibilities for cutting the Massachusetts budget, Jane Little (Federal Reserve Bank of Boston) examined these differences for 50 states.

Little's 67-page study provides considerable detail on factors affecting costs in each state compared to the 49 others. Some of the key conclusions are summarized in Table 4. It shows (1) per capita Medicaid costs, (2) an index comparing the relative percentages of poverty-level people who participate in Medicaid to the national average which is set at 100, and (3) an index comparing the cost per Medicaid recipient adjusting for the mix of caseload. Put another way, the second column compares the success (failure, from another perspective) of getting people into the Medicaid program and the third compares the cost per recipient of those in the program.

Table 4: Medicaid Cost And Cost-Influencing Factors, FY 1989

State	Per Capita Cost	Indices Of: Participation	Cost
New York	$568	103	160
Massachusetts	405	134	119
Minnesota	254	88	192
Ohio	244	138	140
United States	**222**	**100**	**100**
Washington	202	134	121
California	189	115	66
Illinois	180	87	89
Florida	151	88	78
Texas	131	75	93
Alabama	124	67	61

The table's second column suggests that New York's extraordinarily high per capita costs are not caused by eligibility criteria that are out of line with other states. Such criteria do appear to be a significant factor contributing to higher costs in Massachusetts, Ohio, and Washington and to lower costs in Alabama and Texas.

As shown in column three, New York and Minnesota have substantially higher costs per recipient than the other states. This can reflect several factors: (1) higher hospital and physician fees; (2) more extensive treatment, and (3) coverage of elective Medicaid services not provided in other states.

Little's assessment of prospects for reducing costs is not encouraging for those seeking Medicaid savings in state budgets. Not only do federal mandates increase current costs, the mandates being phased in cut off avenues of potential cost saving. Protecting against state cost-saving measures is, of course, exactly what proponents of the mandates were trying to accomplish. Little typically follows her discussion of each cost-saving measure with a discussion suggesting that the costs will reappear somewhere else in state budgets. However, there are some suggestions for cutting cost, particularly in administering asset tests for persons going into nursing homes.

Litigation On Provider Reimbursement Rates Pushing Costs Up

As executive budget offices put the finishing touches on the governors' FY 1993 budgets, reimbursement rate litigation remains a potentially significant cost factor. These cases were initially pursued by hospitals. After their U.S. Supreme Court victory, which established their right to have reimbursement rates decided in the courts, nursing homes quickly joined the action.

The cases don't necessarily result in immediate budget increases, but can result in settlements or ultimately in final judicial determinations that do increase spending. For example, Illinois "lost" its case in October when a federal judge ruled that state officials hadn't used the appropriate procedures and criteria for determining the nursing home reimbursement rate. But the judge didn't order a rate, so now state officials will make a rate determination. It will become subject to litigation if not accepted by the nursing homes.

The next step was recently taken in Pennsylvania. More than a dozen plaintiffs -- representing child advocacy groups, doctors, and others -- are suing the state. Part of the relief being sought is expanding the reimbursement logic of hospitals and nursing homes to physicians. This is the other shoe dropping from the Supreme Court case. The ultimate outcome could be expensive, but the case could stay in litigation for several years. Besides reimbursement rates, the suit goes to the substance of Pennsylvania's program, arguing that the state should do whatever is needed to reach more clients. For example, the American Academy of Pediatrics, one of the plaintiffs, says that the Keystone State is reaching only 18% of the population eligible for its preventive care programs.

Provider Rates And Bootstrap Financing

The provider rate cases arise from a provision of federal Medicaid law which indicates rates should be "reasonable and adequate." Cases under that provision, sometimes called the Boren Amendment after the Senator who sponsored it, could interact with bootstrap financing to leave states holding the bag for rate increases adopted earlier this year. Some states made higher reimbursements contingent on bootstrap financing, but could find they must keep the higher rates without the financing. The Illinois Economic and Fiscal Commission describes the situation in its Autumn Update on state finances.

> *While it is not clear what action the federal government will take, the Illinois assessment program will proceed until a ruling is made. During the first week of October, the Illinois Department of Public Aid billed providers $71 million. Later in FY 1992, provided the federal government's ruling is delayed or dropped, two more billings totalling an estimated additional $370 million during FY 1992 will be made. This would trigger approximately $440 million in federal reimbursements to Illinois under this program in the current fiscal year. If the Medicaid Provider Assessment Program is prohibited in FY 1992, state law requires that unexpended assessments already collected be returned to the providers and that reimbursement rates revert to those in effect last year. This could be problematic, however, given the "Boren Amendment," which requires states to reimburse Medicaid providers at rates that are "reasonable and adequate."*

In simple terms, some states agreed to pay higher rates because bootstrap financing made it possible to pay them without taxing their budgets. Their laws say if bootstrap financing disappears so do the higher rates. But it won't necessarily happen that way. Even

without bootstrap financing, states will face the usual arguments for provider rate increases. They might also face litigation under the Boren Amendment. In that litigation they would face the task of explaining how a rate previously determined to be reasonable and adequate became excessive when federal bootstrap financing rules changed

MISCELLANY

Borrowing Without Debt

In October, the Illinois legislature was debating alternative approaches to the timing of school aid payments. The issues were complex, with a unique vocabulary (e.g., the "thirteenth month school aid payment"), but the substance is simple. The state delays a school aid payment enough to "save" one twelfth of its school aid spending but not so much that schools lose one-twelfth their revenue. In some cases, the state pays interest, which the Illinois governor has been offering.

These kinds of arrangements aren't new. New York has been using its "magic window" for decades. The news is that their use appears to be spreading. The concept of delaying payments and reimbursing the recipient for borrowing cost (lost interest) is applicable to vendors like hospitals providing Medicaid services as well as local governments. The economics is essentially the same as the state borrowing money to make payments. The public perception presumably differs, which is why the device is being used.

Pump Priming

The traditional Keynesian prescription for stimulating the economy is for government to put more money into the economy by spending and take less out in taxes. With balanced budget requirements, there isn't much states can do to fill this prescription. They can't cut taxes without cutting spending and can't increase spending without raising taxes. So the stimulative effects of one policy is offset by the depressing effects of the other.

States can spend borrowed money for capital outlays. The possibilities include accelerating spending for already approved projects and authorizing new projects and borrowing. There are many models of this approach, such as the Build Illinois and Build Indiana programs, though much of the their impact has been in recovery rather than recession periods.

Some governors have talked of similar actions in this recession. Maryland is the latest with what the governor calls "Maryland Goes To Work." Governor Cuomo has applied the concept regionally with a state effort to revive the economy of Long Island. These initiatives aren't having dramatic impacts because of difficulties associated with

accelerating projects such as environmental impact statements, getting legislative approval, and the hang-up of federal highway legislation in the Congress.

Speech Material

For an overall summary of fiscal circumstances suitable as an introduction for whatever a speaker wants to cover, try NCSL fiscal expert Corina Eckl's closing from "Strapped States Face Hard Choices" in State Legislatures (November):

> *As legislators and staff recover from what many describe as their most trying sessions ever, more bad news is on the horizon. With the ink barely dry on recently enacted budgets, many states have already cut budgeted levels for FY 1992 as revenues have come in below expectations. If the national economic recovery is slow, as several economists predict, state lawmakers will once again confront the painful dilemma of reconciling limited revenues with uncontrollable spending demands. 1991 legislative sessions were merely a prelude to 1992 sessions -- not a pleasant thought for most policymakers.*

Taxes, Other State Policies, And Business Climate

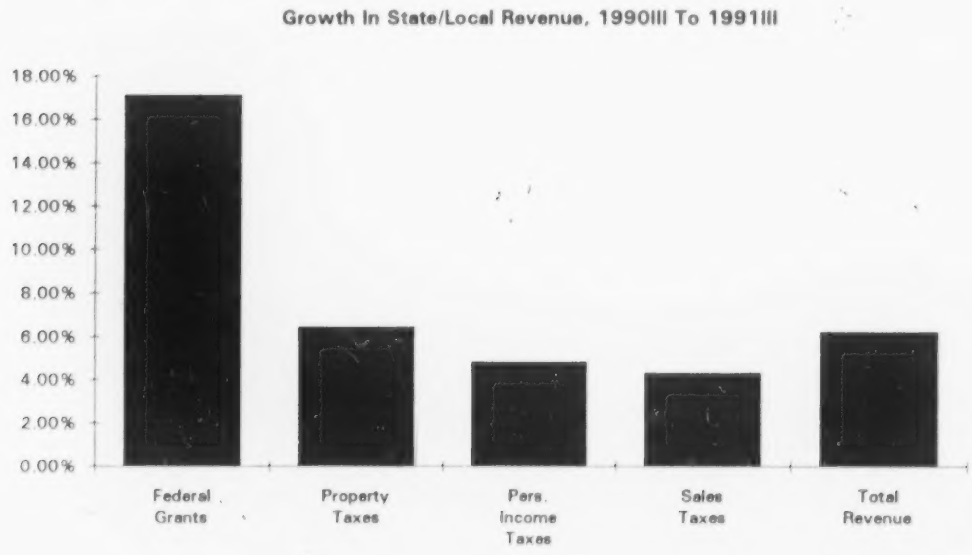
Current issues in Massachusetts provide a reminder that the taxes used to finance state budgets aren't the only game in town for business taxpayers. The three big issues now being considered involve financing that takes place outside the general fund of Massachusetts and other states. One is Workers Compensation, financed by a payroll tax in some states and assessed as insurance costs in others, where a rate increase of 20-50% is in the cards. Another is Unemployment Compensation, where the state is already borrowing from the federal government. A large tax increase -- in the rate, the taxable payroll base, or both -- is in the cards. The third is the fund that pays for uncompensated hospital care which economically works as a tax on health insurance. Boston-area businesses also face escalation in water and sewer charges which are already about $500 a year for a typical household of four and are slated to rise to about $1,000 in 1995 as the construction to clean up Boston Harbor progresses.

The California Chamber of Commerce recently announced results of a poll of more than 1,000 employers on priority state issues. Taxes were the highest priority, as might be expected after this year's tax increase and announcements that there is another major budget shortfall. Workers Compensation was a close second. Other major issues were education, environmental permit procedures and costs, liability law, recycling, and state water policy. The chairman of the Chamber's task force on saving jobs has recently relocated several ZERO Corp. operations to Utah. He notes employees experience lower costs for housing, auto registration, and auto insurance. His Workers' Compensation premiums are 60% lower while health insurance costs are 35-50% lower.

State And Local Finances Bottoming Out?

The state and local fiscal picture isn't good, but isn't any worse than it was a year ago, according to new estimates released by the Commerce Department. In the third quarter of this year, state and local governments ran a deficit of $31.3 billion. That's about the same as the third quarter a year ago and an improvement over the $41 billion deficit of the first quarter and the $33.1 billion deficit of the second quarter. State and local governments run some deficits even in good times, but the current deficit is higher than normal, such as the $20 billion deficit during 1989. One piece of good news is that the rate of increase for spending (6.3%) is about the same as the one for receipts (6.2%). Another is that employee retirement funds are growing at nearly $5,000 for every employee-year being worked.

There are messages in the revenue growth comparison on the chart below.



One message is that federal grants are growing much more rapidly (17.1%) than total state and local revenue (6.2%) or any of the major taxes shown. It is simply incorrect to talk about overall cuts in federal aid to state and local government. The second message may prove to be important as early as the elections of 1992. Property taxes have been rising faster than other major taxes. Public opinion polls indicate voters like property taxes less than sales or income taxes. Legislators and governors generally place considerably more stress on relieving property tax burdens than sales or income tax burdens.

The 6.2% growth in property taxes is significantly larger than some politically salient growth rates during the same period like personal income (3.1%), consumer prices (about 3.5%), market values of homes (probably a small negative number), and market values of commercial and industrial property (probably a large negative number).

TECHNICAL NOTES

Tax Increases: The tax increases shown on Table 1 are the sum of increases reported in annual summaries by NASBO or NCSL as selected at the time as the most useful survey. The increases were reported in **Reports** (Vol. 7, Issue 16, 1989), and State Budget & Tax News (Vol. 9, Issue 18 for 1990 and Vol. 10, Issue 21 for 1991). Tax increases have been defined slightly differently by different reporting organizations and from year to year by the same organization. The percentage for each year is roughly the annual amount of increased revenue from tax changes divided by the prior year's tax revenue. The U.S. figure of 8.8% is the sum of state dollar increases divided by the prior year revenue. The average of state percentage changes is 8.4%. The table includes the 1991 Missouri tax increase of 8.1% put to voters by the legislature and rejected and the 13.2% 1989 North Dakota increase referred to voters by voter petition and rejected by voters.

Higher Education: The data in Table 2 are what is known in higher education as the "Chambers numbers," a long-time data series maintained by Edward Hines of Illinois State University. They appear in his publication Grapevine and the Chronicle Of Higher Education (11/6). They measure resources states add to higher education including scholarships but excluding tuition. Table 3 is based on reports to NCSL by legislative fiscal offices appearing in State Budget And Tax Actions, 1991. Inclusions and exclusions conform to the differing practices of individual states.

Medicaid: Little's analysis, Why State Medicaid Costs Vary: A First Look was published as a working paper by the Federal Reserve Bank of Boston. The data in Table 4 deal with non-elderly persons eligible for Medicaid because they receive cash welfare assistance. There are separate tables in the report dealing with other groups.

Finances: The finance numbers on p. 23 are presented at seasonally adjusted annual rates. They come from the National Income and Product account estimates of the Commerce Department's Bureau of Economic Analysis. To develop the totals shown in the text, **Reports** had to provide its own estimate for corporate profits taxes, which are less than 3% of total receipts. Accounting conventions for gross national produce explain why there is a perpetual state and local deficit. When capital outlays are financed by bonds the bond proceeds aren't counted as revenue but the capital outlays are counted as spending. The personal income tax entry in the chart is the BEA category personal tax and nontax receipts. BEA shows growth of only 2.1% for narrowly defined personal income taxes.